

***United States Court of Appeals
for the Second Circuit***



APPELLEE'S BRIEF

To be argued by

DONALD L. KUBA

77-7169

ORIGINAL

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P/S

IN THE
United States Court of Appeals
FOR THE SECOND CIRCUIT

No. 77-7169

ABNER HARKAVY,

Plaintiff-Appellant,

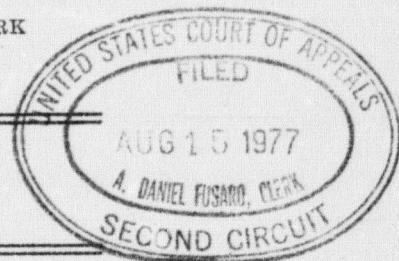
—against—

APPAREL INDUSTRIES, INC. and S. M. ELOWSKY,

Defendants-Appellees.

CIVIL ACTION ON APPEAL FROM THE UNITED STATES DISTRICT
COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF DEFENDANTS-APPELLEES



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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

-----x
ABNER HARKAVY,

Plaintiff-Appellant,

-against-

Docket No. 77-7169

APPAREL INDUSTRIES, INC. and
S. M. ELOWSKY,

Defendants-Appellees.
-----x

CIVIL ACTION ON APPEAL FROM THE
UNITED STATES DISTRICT COURT FOR
THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF DEFENDANTS-APPELLEES

PRELIMINARY STATEMENT

Plaintiff-appellant appeals from the judgment of the District Court entered on March 8, 1977, dismissing the complaint (A 164) following a two-day, non-jury trial before Hon. Dudley B. Bonsal, D.J. The memorandum opinion of the Court, which succinctly answers appellant's contentions, appears at pages 158 to 163 of the Appendix.

This action involves alleged violations of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j(b)) and Rule 10b-5 (17 C.F.R., §240, 10b-5) promulgated thereunder.

The gist of his 10b-5 claim as set forth in appellant's brief (p. 4) is that defendant did not inform him at the time of the stock sales in March, 1969, and January, 1970, that defendant Apparel was about to introduce a new junior line and that Apparel had purchased shares from other shareholders. At the close of the trial, Judge Bonsal ruled from the bench that plaintiff "had not made out a case" and that it was "purely a factual matter" (A 156).

ISSUE PRESENTED

Was the District Court correct in dismissing the complaint?

STATEMENT OF THE FACTS

The essential facts are undisputed.

From June, 1945 to June 1968, plaintiff was employed by Kordeen Manufacturing Co., Inc., a closely held corporation, engaged in the sportswear and knitwear business in Herkimer, New York, and controlled by defendant S. M. Elowsky. (Consent Pre-Trial Order ¶6) Plaintiff is related to defendant Elowsky (A 91). On February 6, 1946, plaintiff signed a right of first refusal agreement at book value for his stock of Kordeen "now or hereafter owned by [him]." Consent Pre-Trial Order ¶7) This agreement ran to Kordeen "or its successors and/or S. M. Elowsky or his personal

representatives" whenever plaintiff desired to sell his shares (Dfts. Ex. A, A 228).

Following a stock split and stock dividend, plaintiff owned 306 shares of Kordeen stock. (Consent Pre-Trial Order ¶7)

In August, 1961, the shareholders of Kordeen, including plaintiff, entered into a plan of reorganization with defendant Apparel whereby the stockholders of Kordeen exchanged their shares for capital stock of Apparel on an 11-to-1 basis. Plaintiff, pursuant to the plan, voluntarily exchanged his 306 shares of Kordeen for 3,366 shares of Apparel. Apparel, a closely held corporation, was engaged through its operating subsidiaries in the women's sportswear and knitwear business and controlled by defendant S. M. Elowsky, its chief operating officer and controlling shareholder. (Consent Pre-Trial Order ¶¶8 a 10)

In June, 1968, plaintiff terminated his employment with Kordeen to form his own business in Herkimer, New York, where he purchased machinery from Kordeen and leased premises from a company controlled by S. M. Elowsky. Kordeen remained a wholly-owned subsidiary of Apparel until it was merged with another wholly-owned subsidiary in February, 1971. (Consent Pre-Trial Order ¶8) In 1969 and 1970, plaintiff's business suffered operating losses (A 10).

In March, 1969, plaintiff approached defendant S. M. Elowsky, the President of Apparel, to sell his stock to raise cash (A 107, 118-119). Elowsky at that time was 77 years

of age (A 14, 129). Defendant Apparel had lost \$101,733 in 1968 and \$234,458 in 1969 (Pl. Ex. 2, A 201). (Consent Pre-Trial Order ¶24)

In March, 1969, Apparel purchased the business of House of Morrison Knitwear, Inc. through an exchange of stock. Plaintiff at that time was informed of the acquisition (A 15, 43 and 160). Concurrently, Apparel and Elowsky entered into a shareholders' agreement with the former shareholders of House of Morrison (A 57, 58). Plaintiff was not informed of the contents of the shareholders' agreement (A 22, 23). S. M. Elowsky recommended to plaintiff that he defer the sale of his Apparel shares until the price of the House of Morrison acquisition had been finally determined (A 87, 89). However, plaintiff elected in March, 1969, to sell 366 shares of his Apparel stock and received \$1,464, representing a book value of \$4.00 per share, less stock transfer taxes (A 13, 86). On January 15, 1970, plaintiff sold his remaining 3,000 shares of Apparel and received \$13,245 in cash, representing book value of \$4.43 per share, less stock transfer taxes (A 17, 89).

Shortly prior to plaintiff's 1970 sale, one of the signatories to the shareholders' agreement, Hanna Rosen Tannenbaum, sold 41,500 shares to Apparel at the price of \$4.43 per share, which was the negotiated book value under the agreement and was the same price paid to

plaintiff for his remaining 3,000 shares (A 61-62, 88-89, 106). In addition, in December, 1969, S. M. Elowsky's sister, Anna Reiss, sold 15,000 shares to Apparel at a price of \$4.00 per share. Each of the stock purchases by defendant Apparel from its shareholders had been initiated by the stockholders themselves (A 107, 109).

POINT I

DEFENDANTS DID NOT HAVE ANY
UNDISCLOSED MATERIAL EXISTING
PLANS AT THE TIME OF PLAINTIFF'S
STOCK SALES

As previously stated, the basis of plaintiff's 10b-5 claim is that defendants failed to inform him, at the time of his stock sales, of plans to market a junior pants line and that Apparel had purchased shares from other shareholders.

Rule 10b-5, implementing Section 10(b) of the Securities Exchange Act of 1934, makes it unlawful:

"(1) to employ any device, scheme, or artifice to defraud,

"(2) to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

The Statute and Rule require that the fraud must have been practiced prior to or contemporaneously with the stock sales in order to come within the qualifying phrase "in connection with." Pepsico, Inc. v. W. R. Grace & Co., 307 F.Supp. 713, 720 (S.D.N.Y. 1969); Schuller v. The Slick Corporation, [1974-75 Transfer Binder] Fed. Sec. L. Rep. ¶95,065 (S.D.N.Y.) 1975).

In addition, the Statute and Rule require that an insider disclose existing "material facts." Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), 404 U.S. 1005 (1971); Kohler v. Kohler Co., 208 F.Supp. 808 (E.D. Wis. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963).

Plaintiff, in his brief, relies on an article in Womens Wear Daily, in November, 1969, that defendants were working on plans to open a junior line in the not "distant future" (App. Brief, pp. 4 and 5; Pl. Ex. 3, A 227).

According to the trial testimony of Max Jaffee, Vice President of Apparel, and S. M. Elowsky, Apparel had no corporate plans to market a junior line before the middle of 1970 (A 65-66). In November, 1969, the status of any plans to reenter the junior pants line was "just talk" (A 112, 114). Apparel did not begin to set up the new business line until Daniel Gray was hired in April, 1970, to begin work on a new junior line. Three months later, in June, 1970, Seymour Bag was engaged to assist Mr. Gray

in the development of this new line (A 67, 94, 114-115, 135, 137, 150-151, 154), i.e., many months after plaintiff's second sale and over a year after the first. Production of the new junior line commenced under the name TROUSERS UP during the summer of 1970 and first shipments began in August, 1970 (A 95, 137; Pl. Ex. 2, A 204). Sales of the TROUSERS UP line for 1970 constituted a small part of defendant Apparel's business. Sales of the new line for the period August to December, 1970, totalled \$780,000 as against sales of nearly \$7,000,000 for all Apparel's product lines in 1970 (Pl. Ex. 2, A 204; Dfts. Ex. E, A 243). The contribution to earnings of the new line in 1970 amounted to \$18,488 out of \$246,821 (A 100; Dfts. Ex. E, A 239).

The success ultimately achieved by Apparel's TROUSERS UP line represented the ability of Daniel Gray and Seymour Bag to detect the fashion trend in the summer of 1970 and to design a new line of pants which met with public acceptance (A 139; Pl. Ex. 2, A 204). Plaintiff testified that he was aware in 1970 that the women's pants line had become fashionable and that this had contributed to the termination of his own business (A 9).

Plaintiff, with the benefit of hindsight, is attempting to bootstrap himself into a cause of action by referring to later developments which occurred well after his stock sales. However, the testimony and evidence conclusively established that there were no specific plans as to Apparel's new junior line in existence at the time of

plaintiff's stock sales. Materiality is measured when the alleged violation occurs and it is clear that defendants did not conceal information from plaintiff, for there was nothing to hide.

In an analogous context, the Sixth Circuit observed in Arber v. Essex Wire Corporation, 490 F.2d 414, at pp. 420-421 (6th Cir. 1974), cert. denied, 419 U.S. 830 (1974):

"Appellants argued, but did not prove, that at the time of the sale, management had definite plans reasonably certain to increase the value of the stock. We do not suggest that a fixed plan of future corporate activity may never be viewed as a material fact. Mere speculation, however, does not provide any basis for Section 10(b) liability. Certainly developments subsequent to the 1961 sale greatly increased the value of the Essex stock and no doubt the Arbers' sale of their shares proved improvident by hindsight. But Section 10(b) does not require that an insider 'confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions.' Texas Gulf Sulphur Co., supra, 401 F.2d at 848. In short, the law mandates disclosure only of existing material facts. It does not require an insider to volunteer any economic forecast."

See, also, Kohler v. Kohler Co., supra, and Harnett v. Ryan Homes, Inc., 360 F.Supp. 878 (E.D. Pa. 1973), aff'd, 496 F.2d 832 (3d Cir. 1974).

In Barnett v. Kirshner, 527 F.2d 781 (2d Cir. 1975), the Court affirmed the lower court's dismissal of a Rule 10b-5 claim on the grounds that plaintiffs had failed to sustain their burden of proof that defendants had sufficiently embarked upon their subsequent purchase of certain lucrative musical properties of Alan Jay Lerner, namely, the musical rights to

"My Fair Lady," "Brigadoon," "Camelot," "Gigi," etc., on or before the times plaintiffs had sold their shares back to the defendant corporation in order to invoke Rule 10b-5. The Court observed at p. 785:

"The court further found as a fact that all three plaintiffs had themselves initiated the sale of their stock which would indicate that they had not been victimized or gulled by a prior conspiracy among the defendants. Barnett had indicated a desire to sell in the summer of 1968; Gordon wished to sell because he was financially overextended, and Hollender because he 'lost faith in management.'"

Plaintiff Harkavy had been involved in the apparel industry for over 35 years and was experienced enough to appreciate its vagaries. He knew of all the uncertainties involved in bringing a new product line to market. At best, plaintiff's claim amounts to the assertion that Mr. Elowsky's intimate knowledge of the apparel industry would have enabled him to predict for plaintiff in January that Apparel would bring to market a new product line, TROUSERS UP, in the summer of 1970 and that the sales results of the new product line would make Apparel a profitable enterprise. Rule 10b-5, however, does not place such an obligation on Mr. Elowsky.

Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, at 848-849, seems particularly germane. The Second Circuit Court stated:

"Nor is an insider obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions. [3 Loss, Sec. Reg. (2d Ed. 1961) at 1463.] The only

regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.

* * *

"In each case, then, whether facts are material within Rule 10b-5 when the facts relate to a particular event and are undisclosed by those persons who are knowledgeable thereof will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."

In Marx & Co., Inc. v. Diners' Club, Inc., 550 F.2d 505 (2d Cir. 1977), plaintiffs, in a 10b-5 claim, asserted that they were induced to sell their business on the basis of defendant's representations concerning the timing of a takeover of another company. At trial, plaintiffs testified that they were told that the takeover was "imminent" and, on appeal, argued that these were "specific representations." The Second Circuit affirmed the dismissal of plaintiffs' 10b-5 claim, stating at pp. 514-515:

" . . . For the defendants never represented as a fact that a takeover would occur within a certain period. They merely gave their general predictions as to future events. Thus, plaintiff Summerlin testified that he had been told that there was a probability of a takeover. Plaintiff Marx recognized that there was only a 'possibility or probability' of a takeover, and he personally participated in attempts to try to effectuate the transaction. Plaintiff William Fugazy was told that it 'looked like' Continental was going to acquire Diners. Given the nature of these statements, we think the District Court properly noted the absence of any representations of specific timing. The general nature of the predictions precludes them from being representations of fact."

Similarly, in the case at bar, the statement in the November, 1969 Women's Wear Daily article that Apparel hoped to introduce a junior line in the not "distant future" was merely a general prediction as to a future event which may or may not occur and not actionable under Rule 10b-5 (Pl. Ex. 3, A 227).

The two cases cited by plaintiff-appellant in his brief at page 7 (Janigan v. Taylor, 344 F.2d 781, and Myzel v. Fields, 386 F.2d 718) are inapposite. Those cases involved failure to disclose material facts such as a backlog of orders and increased sales - matters of statistical certainty, not vague images in a cloudy crystal ball.

The optimistic statement in defendant Apparel's November, 1969 publicized press release was hardly new information that required disclosure to plaintiff. Plaintiff had been informed of the House of Morrison acquisition in March, 1969 (A 15). He knew that Apparel was interested in the junior line (A 97). He knew that by the House of Morrison acquisition, younger executives, namely, Harold J. Rosen and Max D. Jaffee, were brought into Apparel and, if he thought this was significant, plaintiff then had the opportunity of continuing to retain his shares. However, plaintiff, because of his need for cash and because he had lost faith in Mr. Elowsky, then 77 years of age, elected to sell 366 shares in March, 1969, but deferred the sale of his remaining 3,000 shares based upon defendant Elowsky's recommendation. In fact, plaintiff benefited from this deferral, receiving a higher price in the later sale.

Plaintiff also contends (App. Brief, p. 3) that defendants had formulated corporate plans for the restructuring of Apparel's capitalization in the form of the provisions of the March, 1969 shareholders' agreement and the repurchase of shares from other Apparel shareholders. Plaintiff is mistaken. The terms of the shareholders' agreement were not in any sense material information required to be disclosed to plaintiff.

Under the terms of the shareholders' agreement among Mr. Elowsky and the former shareholders of House of Morrison, Apparel was granted a right of first refusal in the event any shareholder party to the agreement desired to dispose of his shares during his lifetime. If Mr. Elowsky died prior to January 1, 1970, Apparel was required to purchase from his estate all shares of Apparel owned by him and his family at the value per share determined as of March 31, 1969, under the House of Morrison plan of reorganization and at book value if he should die thereafter. The agreement also contained similar right of first refusal provisions in the event of the death of the other shareholder parties. In addition, Mr. Elowsky and his family were free to dispose of up to 20,000 shares of Apparel prior to January 1, 1970, and at any time after April 1, 1970, Apparel was required to purchase from Elowsky and members of his family, in the event they desired to sell their stock, such number of shares of common stock at book value to the extent of \$473,000 (A 55, 58; Pl. Ex. 1, A 167-196).

It is undisputed that S. M. Elowsky never exercised any of his rights under the shareholders' agreement (A 102, 103, 117). It is also undisputed that, contemporaneously with plaintiff's stock sales, Apparel repurchased shares of a former stockholder of House of Morrison for the agreed-upon book value of \$4.43 which was the price paid to plaintiff. As with plaintiff, this purchase, too, had been initiated by the shareholder (A 61, 62, 88, 89, 106). Similarly, Apparel also repurchased shares from a sister of S. M. Elowsky, likewise a sale initiated by the shareholder (A 107, 109). There was simply no plan or conspiracy to buy in minority shareholdings.

POINT II

PLAINTIFF, HAVING INDICATED A
DESIRE TO SELL ALL HIS SHARES,
WAS OBLIGATED TO SELL HIS SHARES
AT BOOK VALUE UNDER THE TERMS OF
A STOCK RESTRICTION AGREEMENT

The evidence and testimony at trial establish that plaintiff on his own initiative offered to sell his stock to defendant Apparel because he was in need of funds (A 10) and had lost faith in management (A 14), and that in none of these transactions did defendants engage in any conduct which made the sales in any way coerced.

Plaintiff acquired his stock in Kordeen, a closely held corporation, through S. M. Elowsky, its controlling stockholder, and the stock restriction was entered into for the benefit of Kordeen and its successors and for the benefit

of the interests of S. M. Elowsky (Dfts. Ex. A, A 228). The shares of Apparel remained in plaintiff's hands as a substitute for the Kordeen shares and were bound by the same restrictions (A 98-99). Apparel was also a closely held corporation controlled by defendant Elowsky. Such a restriction, giving the corporation or its shareholders the option of first refusal in the event a stockholder desires to sell his stock, is valid and enforceable under New York law. Allen v. Biltmore Tissue Corp., 2 N.Y. 2d 534, 161 N.Y.S. 2d 418 (1957).

Having offered to sell all his shares back to defendant Apparel, plaintiff thereupon became legally bound to sell his shares back to the corporation at book value; subsequent discussions are not even relevant.

As stated in Schuller v. The Slick Corporation, supra, at \$97,739:

"In this case Schuller was legally bound to sell his shares to Slick when his agent signed the purchase agreement on November 15th. It therefore makes no difference what misrepresentations might be proved to have been made on November 26th; at most they constitute inducements to perform, not fraud under Rule 10(b)-5. Ryan v. J. Walter Thompson Co., 453 F.2d 444, 447 (2d Cir. 1971), cert. denied, 406 U.S. 907 (1972); Fershtman v. Schectman, 450 F.2d 1357, 1359-60 (2d Cir. 1971), cert. denied, 405 U.S. 1066 (1972). See also Blackett v. Clinton E. Frank, Inc., 379 F.Supp. 941, 947 (N.D. Ill. 1974)."

Similarly, in Blackett v. Clinton E. Frank, Inc., 379 F.Supp. 941 (N.D. Ill. 1974), the Court stated at page 947:

"Since the plaintiff was obligated by the 1969 Stock Purchase Agreement to sell his shares of CEF at the time of his termination, whatever he knew or did not know regarding CEF's plans to go public, issue a dividend and have a stock split was irrelevant. Clearly the plaintiff has not properly alleged, nor do the relevant pleadings support a conclusion, that the plaintiff was fraudulently induced into selling his shares of CEF by the material misrepresentation made by the defendants. In fact, the plaintiff apparently had no choice in the matter; he was obligated to sell his stock pursuant to the provision of the 1969 Stock Purchase Agreement as soon as his employer CEF had terminated his services."

In Harnett v. Ryan Homes, Inc., supra, all stock held by employees was the subject of a right of first refusal agreement which required that, when the stockholder left the employ of the company, he sell his shares back at book value. Defendant corporation argued that this agreement precluded application of Rule 10b-5. While the Court did not find it necessary to rule on this defense, it observed in a footnote on page 881:

"5. For reasons we do not find it necessary to develop, the defendants argue that this agreement alone precludes the application of §10(b). While this argument has some merit and is supported by some precedent, we have not decided the case on that point." (emphasis supplied)

POINT III

APPELLANT HAS NOT SHOWN
THAT JUDGE BONSAI'S FINDINGS
OF FACT BELOW WERE CLEARLY
ERRONEOUS

This case was tried by Judge Dudley B. Bonsal without a jury. Plaintiff's appeal is therefore governed

by Rule 52(a) of the F.R.C.P., which reads, in part, as follows:

"Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses."

Plaintiff must establish that the findings by the court below were clearly erroneous. This is a heavy burden, especially since the trial judge had the opportunity to judge the credibility of witnesses. Hedger v. Reynolds, 216 F.2d 202 (2d Cir. 1954).

As Judge Learned Hand stated in United States v. Aluminum Co. of America, 148 F.2d 416, 433 (2d Cir. 1945):

"It is idle to try to define the meaning of the phrase, 'clearly erroneous'; all that can be profitably said is that an appellate court, though it will hesitate less to reverse the finding of a judge than that of an administrative tribunal or of a jury, will nevertheless reverse it most reluctantly and only when well persuaded."

Recognizing the advantages held by the trial court in evaluating demeanor testimony, Judge Hand noted that when a trial judge has seen the witnesses and has made findings as to "whether they spoke the truth, the accepted rule is that [the findings] must be treated as unassailable." (Citations omitted), Id.

Moreover, this Court must also consider the reputation and standing of the trial judge for experience, discernment, reliability, carefulness and probity.

5A Moore's Federal Practice, ¶52.03 [1].

The trial judge was Judge Bonsal, who has been a trial judge since 1961 after a distinguished career at the Bar. "Appellate courts should be slow to impute to trial courts a disregard of their duties and responsibilities or a want of diligence or perspicacity in evaluating the credibility of witnesses and the weight of evidence."

Noland v. Buffalo Ins. Co., 181 F.2d 735, 739 (8th Cir. 1950).

Unless Judge Bonsal was so patently wrong after listening to evidence and witnesses and rendering his decision, the Court of Appeals must affirm the decision of the court below.

CONCLUSION

The case presented only fact questions which were resolved against appellant. The judgment of the District Court dismissing the complaint should be affirmed.

Respectfully submitted,

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Service of three (2) copies of the within
is hereby admitted

this 15th day of Aug. 1977
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Attorney(s) for